CREDIT POLICY MANUAL

USAID | Iraq Economic Governance II

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TABLE OF CONTENTS

INTRODUCTION

Credit Policy Manual

The Bank has adopted this Credit Policy Manual, which is designed to be consistent with sound and prudent bank lending practices in use elsewhere in the world. The manual's purpose is to provide all personnel with a comprehensive understanding of how credit of any nature is to be extended by the Bank. It is expected that there may need to be periodic exceptions to the policies contained herein, and prior written approval must be obtained from the Bank's General Manager or Senior Credit Officer before any commitments or advances may be made pursuant to an exception.

The manual has been developed from existing policy and procedural instructions as well as external sources. This manual and subsequent updates issued by the Bank will help further define the bank's credit policy and serve as a primary reference source for all credit-related issues. Any proposed changes must first have the approval of the Bank's Senior Credit Officer.

The policies outlined herein are intended to be general in nature and will be supplemented by various procedures, which will contain implementing details. Furthermore, they are supplementary to requirements outlined in various Central Bank of Iraq Circulars and other internal policy documents.

This is intended to be both a sound and practical manual. It is also instructional. However, no manual can replace prudent business judgment, sound assessment of the borrower's ability, capacity, integrity, and wise structuring of a credit facility that is appropriate to the needs of both a borrower and the Bank.

This manual is also a living document and will be periodically reviewed and up-dated. It is being presented in loose-leaf form to facilitate a page-by-page update process. Each page is dated, and the Table of Contents (which will be re-issued with each change) will indicate the most recently issued version of that page or section. The manual's value lies in the fact that that it communicates to all staff involved in lending activities the policies and procedures of the Bank, and insures that all staff has current and consistent guidance.

This Manual is strictly an internal document and intended for guidance in the lending process by branch managers, lending officers, credit department managers, credit committee members, other members of bank management and directors. It is not to be distributed to outside parties such as other Banks, prospects, interested borrowers or any other institution or individual.

Lending Personnel

All bank employees involved with lending are directly accountable for their actions to their supervisor and shall operate through the chain of command within the various lending functions.

Bank employees are responsible for maintaining the highest standards of performance by:

- Thoroughly understanding and adhering to the bank's credit processes, policies, standards, and product requirements.
- Effectively balancing productivity and quality.
- Ensuring that personal interests do not conflict with their responsibilities and duties.
- Upholding the ethical standards of the bank in every aspect of performance.
- Acting to best serve the long-term interests of the Bank while prudently meeting the reasonable needs of its clients.
- Respecting other professionals of the Bank.
- Maintaining uncompromising integrity.
- Confronting differences of opinion openly and constructively - speaking up when issues need to be resolved, listening to differing views, and embracing new ideas when it becomes apparent that pre-existing beliefs are no longer valid.
- Holding all bank and client-related information in the strictest confidence. The only exception to this policy will involve the release of limited information necessary to establish or maintain credit and to report the Bank's experience in so doing.

The Branch Manager and head of the Credit Department occupy key lending positions within the Bank. Lending personnel are accountable for their credit recommendations and should consider whether or not recommending or approving a credit is the *right* thing to do for both the Bank and the borrower. A recommendation does not imply that he or she believes a credit to be without risk. Rather, it means that he or she understands the Bank's credit standards and applicable policies, has identified the risks involved in the credit, and believes that those risks are prudent for the bank to undertake. No one should ever advocate an extension of credit without doing all of the preliminary work necessary to fully understand it.

Credit employees in any capacity are responsible for taking action if they see a shortfall in staff, systems, or professionalism. This includes problems relating to those issues, which have affected or may affect a credit decision, even if the employee raising the issue is not directly involved in the decision process. The credit staff must cooperate fully with Internal Audit as well as with outside auditors and regulators.

PURPOSE OF LOANS

Loans are made for many purposes. The Bank should have a detailed understanding of a loan's purpose in order to assess risk and be able to structure financing to the benefit of both the client and the Bank. Loans that have a legitimate purpose in accordance with the policies of the Bank serve to provide liquidity to the economy and financial support to the commercial and industrial sectors in support of economic growth.

The Bank's loans should:

- Support or expand the productive capacity of Iraqi businesses
- Utilize domestic inputs and suppliers which help forge strong integration of the economy
- Create the potential for exports and the development of foreign exchange
- Support private sector development
- Support the development and growth of individual firms
- Maximize the opportunity for employment growth
- Reduce import dependency
- Conform to the instructions of the Central Bank of Iraq and provisions of local and national laws

ELIGIBLE BUSINESSES

Industry Sectors

The Bank makes loans and facilities available to a wide range of commercially viable companies generally categorized into seven primary sectors:

- Commercial
- Manufacturing and Industrial
- Agriculture
- Processed Food
- Building and Construction
- Tourism Projects
- Services

LOAN APPLICATION PROCESS

Loan Application

The client completes the Credit Application with the assistance of the Branch Manager or his/her delegated Loan Officer. A suggested format for the Application is found in Appendix A. This form will help insure that adequate information about the financial condition of the borrower is obtained. The application should be filled out as completely as possible to provide sufficient information with which to begin the analytical process, form the basis for an initial site visit and understand proposed collateral.

One of the objectives of thorough initial visits with the client is to determine the client's character, business condition, prospects, and to gather supplemental financial information. Identification and appraisal of collateral is also essential during initial visits. As an aid to gathering this additional information and supplementing the material provided by the client on the application form, the Loan Officer's Transaction Summary section of the Approval Form should be used as a guide. This form can be found in **Appendix B**.

Credit and Character Review: Credit References

The way a potential borrower handles its obligations with other creditors, such as lenders and suppliers, is a strong indication of how it will handle its obligations with the Bank. Therefore, we should ask questions of other creditors concerning their experience with our potential borrower. Answers to these questions will increase understanding of the credit and make loan officers more confident about proposing sound loan recommendations. What kind of questions should be asked? The basic one is: does the potential borrower honor its obligations on a timely basis. Additional questions, which will provide more in-depth information, might include:

- When did you first deliver goods to this client?
- When did you first establish credit terms (or lend money) to this client?
- What is the highest amount of credit approved for this client?
- What is the current outstanding balance?
- Will you continue to grant credit terms to this client?
- How often is payment received? When was the last payment received?
- Are payments received on a timely basis?
- Has the client ever defaulted on a payment? Was legal action ever threatened/initiated?
- Do you consider the client a safe credit risk? Why?

When checking with another bank, try to obtain information on collateral, interest rate, tenor, maturity date, payment amount, outstanding balance, status of payments (current, past due, etc.) and past repayment history. The goal here is to obtain as much pertinent information as is possible while providing only a minimal summary of the Bank's relationship or reason for inquiring as is possible.

Written confirmation of credit references, if possible, is important because it indicates that the information is most reliable. In many instances, refusal to provide written confirmation means that the information is not reliable. When written confirmation is received, it should go into the credit file.

How many credit references are needed? Key suppliers representing over 20 - 25% of the dollar volume shipped to the client and all Bank lenders within the past three years are considered important credit references. These results should be summarized in the Loan Recommendation. General statements such as "the supplier confirmed good relationships" or "good cooperation with the client" should be avoided since such statements are not meaningful.

ANALYSIS OF CREDIT RISK

Credit risk analysis begins with the clear and careful identification of risk factors such as:

- Background of the borrower
- Purpose of the loan
- Source of repayment
- Owner's background, character and management capability
- Value of collateral and guarantee(s)
- Cash flow and financial strength of borrower, owner and guarantor(s)
- Ability to penetrate market sectors and competitive factors
- Environmental issues

Loan Recommendation to Credit and Advisory Committees

A Loan Recommendation provides information about the borrower and analyzes each risk factor. A recommended format is found in **Appendix B.** It consists of two parts:

1) The Transaction Summary Page contains the essential information for review by the Credit and or Advisory Committees. It contains numerical information in the top section and a Transaction Summary on the bottom. The Transaction Summary briefly recaps analytical findings. Anyone should be able to look at this summary and understand the nature of the transaction, the risk factors involved and why the risks are acceptable.

2) The Write-Up or analytical pages (The "Recommendation Support") supports and expands on the points in the Transaction Summary with more detail and analytical information.

The Transaction Summary and Write-Up will be organized into the following sections with brief statements covering the following:

- Background: State the nature of the borrower's business and background - at a minimum describe the main business activity (agriculture, trade, tourism, industrial, etc.) and a brief history (when and where founded). If client has had Bank-approved credit before, state the status of the previous loan and repayment history.
- Purpose: State the purpose of the loan, use of loan proceeds, the sources of other funds involved and sources of repayment for Bank's loan or facility. Frequently, loans and facilities are used to purchase raw materials (**Appendix E**), equipment, buildings, or to increase capacity. The write-up should contain a chart showing the sources and uses of all funds required to complete a project or a business plan.

Attention should be directed as to how in measurable terms the Bank's loan will improve or impact the borrower's business operation. For projects, this section should describe what the project is about and the kinds of changes the Bank's financing will bring about.

- Ownership and Management: State management's character, its ability to manage the business successfully and comply with the terms of the Bank's loan agreement. If ownership is different from management, discuss. Describe in the write-up pertinent management skills and experience, and the owner's other business interests. Try to identify any additional personnel who are critical to the successful operation of the business. Comment on availability of successor management and technical experts.

- Collateral: State the value of the collateral. Most recommendations should include the owner's personal residence as collateral. If there is a reason a residence cannot be pledged or the client wants to delete this as mortgage collateral, the write-up must clearly state why not and justify the exception. The method used to establish all collateral values and the basic loan-to-value ratio are included here. Collateral charts are required in the write-up along with a short discussion of any ownership issues and collateral insurance.

- Market Information, Industry/Competition: State the industry, market penetration issues, industry comparisons and competitive factors. The write-up covers market penetration in detail, i.e. sources of projected revenues, who are the buyers, and why buyers buy from the Bank's client etc.? How will the borrower exploit competitive advantages or compensate for competitive disadvantages? Price, suppliers, and other customer information may be discussed here along with results from credit inquiries with main suppliers. When checking credit references, Credit Administration should confirm amounts of liabilities as represented in the financial statements as well as those from the CBI registry, and put the findings in the write-up.

- Financial Information:

  I. Borrower Presentation

  - The Transaction Summary should state the latest sales and net income information; debt service ratios may also be included.
  - In the write-up the financial analysis should include the borrower's sources of income and cash flow and its underlying financial condition, as demonstrated by reliable financial statements.

A. Financial Statements

1. It is normally desirable that all loan recommendations be accompanied by three years of historical financial statements and, at a minimum, must include a current balance sheet and income statement. Cash flow statements for prior years for medium term loans would also be desirable. If a company has been in existence less than three years, the most recent year-end statement is required plus any other available information. Depending on the time of the year, reference to six or nine-month interim financial statements may be appropriate. The analyst is expected to verify historical financial data by inspecting tax statements, invoices, contracts and other financial information that may be available.

Every effort should be made to obtain meaningful financial statements for at least the prior year along with projections for the current year and at least the next, showing the impact of the requested financing. In many instances, the analyst will find it informative to examine sales levels since the war on a monthly basis.

2. For medium to long term loans, presentations must show annual projections of the income statement, balance sheet and cash flow information going out one to three years (depending on the loan maturity). For loan maturities longer than three years, the number of annual projections must match the final loan maturity.

3. It is often preferable that the borrower presents monthly cash budget projection for the first year. This demonstrates that the borrower is reasonably anticipating his cash inflows and outflows (including debt service) in a detailed manner.

II. Financial Analysis

A. Historical Performance

1. Start with the **income statement.** Use trend and ratio analysis to identify financial changes. Explain year-to-year material changes in sales, direct costs, general and administrative expenses, and net income. Margins should be studied and discussed. References to sales changes must be consistent with prior analysis of the market and customer preferences.

2. Then, go to the **balance sheet** and focus on current assets, fixed assets (are these values realistic?), current liabilities, long-term liabilities and capital accounts. Use trend and ratio analysis to identify financial changes from year to year. Among other considerations:

a. how does the company fund operations, sales growth and capital purchases?
b. are the levels and changes in various accounts consistent with corresponding income statement accounts? For example, is there a close relationship between sales, receivables and sales terms?
c. how well does the company manage current assets and current liabilities? A summary of a recent accounts receivable and payable aging should be presented. Are results consistent with the terms offered to customers and suppliers?

B. Future Performance

1. The main focus is to determine if projected cash flow**,** using realistic assumptions, is sufficient to repay all liabilities in a timely fashion. Consider:

a. Impact (levels and timing) on the balance sheet and income statement from Bank financing and from any contribution from the owner.
b. Financial projections showing cash levels at unusually high levels. More precise changes in the levels of projected accounts receivables/payables, inventories and fixed assets will produce more realistic cash levels.

2. Owner interactions with the company can have a major effect on cash flow:

a. Owners may be accustomed to taking cash from the company and may continue to do so, regardless of negative loan covenants. Most companies don't pay dividends but salary expense rarely states what owners really pay themselves.
b. It is common for owners of a small to medium-sized businesses to lend money to their business and/or borrow money from it. The latter activity can take the form of borrowings, dividends or simply unexplained cash withdrawals.

3. Projected cash flow analysis will consider all of the above, stating underlying assumptions and why they are believed to be reasonable.

C. Other Considerations

1. Record Keeping. A company's records and accounting methods are important for accurate financial and tax reporting and should be assessed by the analyst. If information in the financial statement and tax statement is different, the analyst should identify the reason for the differences. It may be advisable to request a ledger printout.

2. Accounting Standard. Bank borrowers will have to present financial statements in accordance with IAS, when they are in place.

3. Senior Financial Officers. The competence and integrity of the company's financial manager or chief accountant are important. Timely repayment of loans is directly related to adequate financial management.

4.Tax Information. Companies do submit financial statements to the tax authorities. These statements may be useful for financial analysis purposes as they can show:

- Profitability trends using Sales to Gross / Net Profit Margin ratios
- Liquidity indications using Current and Quick ratios
- Leverage indications using Debt to Net Worth ratios
- Efficiency indicators using Accounts Receivable/Payable and Inventory Days as well as Assets to Sales ratios
- Independent information about operating cash flow, investments in fixed assets, other liabilities, and how the company is repaying all liabilities.

III. Guarantor Presentation:

The Loan Application should be accompanied by a recently completed and signed Personal Financial Statement (PFS) of *every* guarantor, whether third party or owner. A revised PFS form is attached as **Appendix K**. Many borrowers are small, entrepreneurial organizations owned by one or two people who should guarantee loans made to their companies. The Bank's loan officers must coach owners on how to complete an accurate and informative PFS. This allows assessment of the value of the guarantee, cash flow between owner and borrower, as well as issues related to control and co-mingling of assets. For example, the value of a sole owner's interest in a business shown under PFS Assets should be similar to the amount of total capital shown on the business' balance sheet. Assessing the value of this and other assets in light of the owner's liabilities is important. Income from the business is always shown. There is, or should be, a close correlation between the value of a borrower's investment and the business income derived from the business and the information in financial statements. Complete and accurate information helps in understanding character, intent and risk and also assists in the writing of covenants in loan agreements and improves monitoring. The PFS is an important part of the loan approval and monitoring process after loan approval. Thus, each time financial statements are requested from a borrower, the guarantor's Personal Financial Statement should also be updated, reviewed and placed in the credit file.

When the guarantor is a legal entity, an income statement and balance sheet signed by the owner should be obtained in addition to any additional collateral obtained. Guarantors should disclose all other guaranties given.

- Environmental Issues: addressing environmental issues is important if there is any negative impact on the environment of the financing.
- Risks: In the Transaction Summary include a brief explanation of the risks of the loan, how risks are mitigated, and why the loan is recommended for approval.
- Exceptions: Credit Policy Exceptions, if any, are briefly stated at the very bottom of the Transaction Summary and expanded upon with a justification in the body of the Write-Up.

The above points are basic. All analyses, at a minimum, should touch on these points. The analysis should be supported by facts, not opinions or generalities. These are minimal requirements so the analyst can be creative and expand where appropriate.

LOAN STRUCTURE AND TERMS

Background

After the Credit Department has assessed credit risks and the Branch Manager has decided to proceed with recommendation of the credit, he or she has the responsibility to carefully structure the credit transaction so that risk and uncertainty are minimized. This can be done through the use of affirmative or negative covenants (a written agreement to do or not do certain things), the use of third party undertakings (written agreements by others to do or not do certain things), the taking of collateral and collateral insurance, or other appropriate arrangements. If there are existing credit agreements with other lenders in place, the Branch should scrutinize these carefully to determine what rights and remedies the Bank would have under the terms of those existing agreements. This is particularly important in determining the Bank's relative seniority in claims on the client's assets, or in claims for payment due.

Amount

The amount of the loan or facility should always be based upon the realistic need of the company to borrow to support equipment and machinery purchases, undertake construction, buy specific and identified inventory, or working capital for reasonable periods of time. This need must be analyzed carefully given the data provided by the borrower coupled with a realistic assessment of the projected cash flows to repay the loan.

Requests for credit that overstate actual needs should be refused, and not simply cut back by the Credit Committee to an arbitrary lower level. It is not the function of the Credit Committee to arbitrate the exact size of a loan; its proper role is only to determine if a loan request in the context of a specific business plan makes both economic and credit sense.

Lending personnel must also be cognizant that otherwise legitimate credit requests that are inadequately funded create additional risk if borrowers' business plans cannot be fulfilled.

Disbursement

Loans may be structured with multiple advances based upon attainment of certain milestones, for example the completion of certain portions of a construction project.

Tenor

Tenor shall be structured to meet the needs of the business and not to provide the longest possible repayment period:

- For short-term working capital purposes, loans or facilities may be structured up to 12 months for seasonal support of inventory and accounts receivable. Tenor and "clean up" (mandatory "out-of-debt to the Bank") periods are subject to the operating cycle of the business and should be subject to annual review.

- For working capital financing beyond the operating cycle, loans can be structured for beyond one year, provided acceptable collateral margins exist and there is a well identified need for this kind of financing.

- For equipment financing, loans may be structured for periods longer than a year, and for large capital equipment or project financing, for multiple years on an exception basis; but payment schedules should always match projected cash flows. An unnecessarily accelerated repayment schedule can jeopardize the client's ability to repay the loan.

- For agricultural financing, loans are structured so that the payment schedules correspond as closely as possible to anticipated cash generation.

- For major project financing, loans structured on a long-term basis are subject to analysis of:
  - purpose of the financing
  - competitive financing proposals
  - economic factors
  - business plan and feasibility study
  - projected cash flow.

- Every continuing loan or facility should be reviewed at least annually based on updated financial information.

Principal Payments

The amount of monthly principal payments will be structured depending on business needs and projected cash flow. Seasonal influences on the business cycle are also considered.

Interest Rates and Fees

These should be determined on a case-by-case basis by the Branch Manager and reviewed by the Credit Committee for appropriateness and consistency with Bank policy. The CBI no longer administers interest rates so they should be set to be competitive, and provide adequately for contributions to loan loss provisions and to overall Bank profitability. In determining the interest rate appropriate to a particular loan, an increment may be added to the Bank's base lending rates, which reflects risk, anticipated profitability and the value of the overall customer relationship with the Bank.

Grace Period

Circumstances may dictate that the borrower may need a brief grace period on principal loan payments in order to provide enough time to commence production and resulting cash generation. This grace period may run up to six months, but normally is shorter. In cases where the borrower's existing business is already producing sufficient cash flow to make the loan payments, any grace period is clearly inappropriate. Any grace period should be tied strictly to the *actual* needs of the business and not simply to an arbitrary request of the client.

Guarantees

The guarantee of the owner(s), and perhaps also of certain key personnel, of the borrowing company is always required and will serve as a secondary source of loan repayment. Third party guarantees may also be appropriate to support certain loan requests. If collateral pledged by the borrower is weak, additional collateral can be required from guarantors.

Currency

Loans will normally be denominated in either Iraqi Dinars or US Dollars. The appropriate currency will be determined by the specific needs of the borrower as supported by the Bank's currency position at the time of borrowing.

Collateral

Collateral is required as a secondary source of loan repayment. At a minimum, any equipment, building, or other asset purchased with loan proceeds (not including raw materials or inventory) should be pledged or mortgaged to the Bank as collateral for the loan. Moreover, the primary place of business and/or production is required as collateral. As stated previously in the section on Credit Risk Analysis, the business' owner (and sometimes another guarantor) should be asked to mortgage a residence as collateral for the Bank's loan.

- Obtaining Collateral

It is the Branch Manager's responsibility to adhere to the following guidelines:

- Place and Timing of Registration – All existing collateral will be duly registered with the appropriate local and/or national authorities before a loan is disbursed. Collateral purchased with loan proceeds will be registered as soon as possible after purchase or construction is completed. The Bank's Loan Agreement should identify collateral purchased with loan proceeds to facilitate checking after purchase or completion of construction, ownership, or acquisition.

- Value – The general coverage guideline is a function of Bank policy, the instructions from the Central Bank of Iraq and the judgment of the Credit Committee. For example, if the collateral is cash, a loan-to-value ratio of 100% would presumably be sufficient. If the collateral is of lesser quality or liquidity (for example: accounts receivable, inventory, equipment or real estate), coverage should be higher, and in some cases, substantially so. It should be remembered that loans, especially problem loans, rarely get repaid out of the liquidation of collateral.

- Appraisals - Collateral appraisals will be reviewed for accuracy and reasonableness by using other comparisons such as cost or, where available, market values. Collateral values will be stated in the Loan Recommendation (see previous section under Credit Risk Analysis).

Collateral Insurance

As and when Iraq's insurance industry recovers, Property and Casualty insurance should be required on all collateral and property acquired from the proceeds of the loan. Insurance policies should be endorsed to the Bank as Lender, name the Lender as the Loss Payee, and direct any payments of claims to the Lender.

Collateral is usually structured on a case-by-case basis. In theory all collateral (including any residence involved), especially that which the Borrower relies on to generate cash flow, should be insured along with any other collateral a guarantor might provide separately from business collateral.

Key Man Life Insurance

The need for Key Man Life Insurance should be considered. Key Man Life Insurance (KMI) may help cover the risk of premature death of an owner/manager or key technical employee of a business that would add significantly to credit risk. Although there are no hard and fast rules as to when it should be required, KMI may be considered when the death or disability of a key person would:

- Create a void that could not be filled from current personnel
- Upset the normal operations of the business which could lead to the company's demise
- Impair the company's relations with key suppliers (i.e. credit terms) or its clients
- Upset the financial control and management of the company
- Mean a loss of specialized skills unique to the business
- Halt or delay an important marketing campaign or production schedule

The size of a loan facility may be a good reason as well.

Many borrowers are small to medium-sized enterprises and for that reason should be considered for KMI. Because the policies are written with the Bank as Loss Payee, in the event of death bank loans can be fully or partially repaid from the policy proceeds.

KMI is mostly optional from the Borrower's viewpoint. It may be too expensive for some borrowers and may not be available in sufficient amounts. However, it is a matter of the best judgment of the Credit Committee as to its necessity, coupled with understanding of its importance by the Borrower.

Loan Renewals, Restructures and Foreclosure (legal action) Recommendations to Credit and Advisory Committees

Such recommendations should follow the above order and details of presentation as on the Cover Page of the Loan/Facility Recommendation Form. Foreclosure (legal action) recommendations do not need to present the same level of detail for a financial analysis of the Borrower or Guarantor.

For restructures, explanations should outline why the borrower did not pay as agreed, and indicate how the new terms and conditions will minimize the chances of a recurrence.

COMMUNICATIONS

Confidential Information

It is the policy of the Bank to respect and preserve client confidentiality. Therefore, any information obtained regarding a Bank client while gathering references, analyzing a loan request or monitoring a loan will be held in confidence. Such proprietary information must not be allowed outside of the Bank without written client permission. A client must understand that any information provided to the Bank will be held in confidence so as to encourage him to freely provide the information necessary to adequately support any requested transactions.

DOCUMENTATION

Legal Compliance and Conflicts of Interest

The Bank will comply with all applicable laws and regulations regarding the extension and documentation of credit. This includes adherence to all instructions issued by the Central Bank of Iraq. It is the policy of the Bank to avoid all conflicts of interest and to carry out fully all fiduciary responsibilities that have been vested in the Bank or its staff.

Documenting Loan Arrangements

It is the Branch Manager's responsibility to insure that all credit arrangements and agreements are carefully documented for the bank's permanent records.

Standard Agreements and Legal Counsel – All loans will be supported and documented with standard loan agreements. Documentation of unusual conditions and covenants must be reviewed and approved by the bank's legal counsel.

Preparing Document Files – It is the Branch Credit Administration's responsibility to obtain all original documents related to a credit transaction, including closing documents, opinions, certifications, etc. as well as documentation listed in **Appendix A**. It is the responsibility of the Branch Credit Administration to insure that collateral documents are complete and that liens are perfected.

Third party guarantees in the Bank's favor represent credit exposure since the bank is relying ultimately upon the guarantor's support to repay the loan or facility. The Branch Manager and Credit Administration must insure that all such guarantees are properly documented and in force.

- Each guarantee must remain in force until the termination of the obligation that is guaranteed.
- A guarantor must have the legal capacity to issue a guarantee.
- All documentation is to be included in credit records and must be proper and in order.
- If possible, a standard form of guarantee without limitations should be used. Where this is not possible, counsel should examine the guarantee document.
- Particular care must be exercised with personal guarantees because of the vulnerability to the diminishment or transfer of assets, as well as difficulties in enforcement.
- Guarantors and the amount of their commitments must be reported to the Central Bank of Iraq.

Guarantees that the Bank issues on behalf of its clients and in favor of third parties should be treated and analyzed like any other extension of credit and supported by the Bank's standard documentation and conform in all respects to the terms of the Credit Committee's approval.

Guarantees may be obtained from a foreign Bank to protect advance payments made by Bank clients for the purpose of importing goods and services. This is frequently an alternative to issuing import letters of credit. An example of an appropriate guarantee for advance payment is found in **Appendix L** and foreign Banks should be asked to follow the wording of this document as closely as possible.

LOAN CLOSING

Loan closings represent the end of an approval process and the beginning of a relationship process, which involves many different activities on the part of borrower and lender, which include, among other processes, repayment, monitoring and possibly collection activity.

All new loans and facilities must be evidenced by a signed agreement. Amendment agreements based on restructure or rollover approvals that include, apart from revised repayment schedules, important changes or additions to existing covenants, should require loan closings.

A loan agreement is a contract between lender and borrower. A borrower should know precisely what he is receiving; how the loan is structured; how the Bank intends to monitor and how it will enforce any special terms and conditions of the contract. Also, under the terms of the loan agreement, the borrower acknowledges its responsibility to promptly advise the bank about any inability to repay contractually and also of any material changes in circumstances which could give rise to an event of default in an agreement.

Loan closings give the Branch Manager an opportunity to express formally the Bank's expectations with regard to borrower performance and to make sure that a borrower fully understands the content of the agreement. Specifically, the Branch Manager responsible for the relationship should review any important covenants and/or undertakings with the borrower.

MANAGING RISKS
AFTER LOAN APPROVAL

DISBURSEMENT CONTROLS AND PRACTICES

In the event approval documentation requires specific conditions of borrowing, it is essential for the Branch to insure that disbursements are made strictly in accordance with those conditions.

The Branch will carry out the following procedures:

- Disburse only upon presentment of final invoices, not pro-forma. Verify during subsequent monitoring that goods have actually been received.
- In the rare event that payment is needed in advance, ensure that a valid Letter of Credit, Advance Payment Guarantee or other performance security of delivery issued in the Bank's favor is in place prior to disbursing funds. Follow up by obtaining a copy of the final invoice and comparing the amount to what was disbursed.
- Ensure invoices that evidence approved expenditures with loan funds contain adequate detail in order to assess value (complete descriptions, age of equipment, condition, etc.) If reimbursing for services, ensure that receipts are attached to support purchases.
- If the borrower is purchasing equipment through a third-party supplier rather than directly from the vendor, ensure that the supplier regularly deals in this type of equipment and not merely that the borrower has done business with the third party supplier for unrelated items. For example, the third party supplier has been used in the past to purchase raw materials and the borrower suddenly wishes to use him for the purchase of equipment. Unless this supplier has previously had extensive experience in supplying this type of equipment and it can be proven, do not disburse to the supplier. Borrowers frequently use this type of arrangement to divert loan funds for unauthorized purposes. Payments should only be made to known and proven suppliers of the specific type of equipment in question.
- During site visits, be aware of other projects the borrower may be working on to ensure Bank funds are not being used for them rather than the approved project.
- All collateral must be registered before any disbursement is made.
- Prior to issuing progress payments for construction work, obtain independent technical verification of actual construction status and costs expended to date.

MONITORING ONGOING CREDIT RISK

Credit risk is a dynamic variable, subject to rapid change. In order to manage credit risk effectively, it is the Bank's policy that officers and staff follow closely the ongoing activities and operations of all clients, anticipating the impact that economic and market events might have on businesses being financed.

Loan Monitoring Strategy

The primary responsibility for monitoring the ongoing credit risk of individual transactions lies with the Branch Manager and Loan Officer, and as required, specialized credit staff. Monitoring will include:

- Review of patterns of credit usage – To insure that the credit facilities are being used appropriately.
- Regular (no less than quarterly) contact with the client – The Branch Manager will maintain regular contact with the client in order to stay abreast of events affecting the borrower's business or sources of income and cash flow. This responsibility includes all extensions of credit.
- Review of periodic financial statements – The Branch Manager or Loan Officer arranges to receive in a timely manner and analyze all periodic financial statements of the client. This responsibility exists for all loans and facilities approved and fully or partially disbursed, or approved but not disbursed at all.
- Ultimate collection of Bank loans and facilities – Each Branch Manager or Loan Officer will be expected to take whatever prudent, timely and lawful steps are necessary to insure that the loan remains collectible. It is expected that deteriorating credits will be brought to the immediate attention of the Main Office head of Credit Administration.
- Being responsible for the Credit File – The Branch Manager and Credit Administration staff are responsible for the creation and maintenance of the borrower's credit file.
- Six Key Indicators (current levels of Sales, Cash, Accounts Receivable, Accounts Payable, Inventory and Other Bank Debt) – are to be obtained on a quarterly basis for loans that are fully or partly disbursed, and as frequently as is practical for loans that are approved and not disbursed.
- A suggested Monitoring Form is found in **Appendix C.**

Covenant Monitoring and Defaults

The Bank's Loan or Facility Agreement is a business contract and contains terms and conditions that clients must observe. Monitoring covenants in addition to monitoring overall borrower performance is essential to the process of lending and getting repaid.

After disbursement, and as the Bank begins to regularly monitor performance on a monthly or quarterly basis, if violations of covenants or other conditions of borrowing are observed, the Bank should advise borrowers that they either are or may be in default. If a borrower properly understands the terms, covenants and conditions of lending, it is the borrower itself, which would be required to initiate the communication so that the Bank can discuss corrective action.

In all cases the Bank should immediately bring violations to the borrower's attention verbally and follow up with a default letter, if necessary.

Renewing Credit Facilities

In renewing Loans or Facilities, the Bank should make an independent assessment of credit risk as though it were an entirely new transaction, and as such will be approved in accordance with the appropriate approval authorities. Mandatory review and renewal of existing facilities should take place at least once a year, even though facilities may have been initially approved for a longer period.

LOAN MODIFICATION

Policy

On occasion, a client may wish to amend originally approved credit terms. Changes may be necessitated by many different events, including one or more of the following: the passage of time, changes in business conditions and/or plans, inexperience of the borrower at forecasting its needs when the loan process is started, changes in collateral and delays in business events or in obtaining documentation.

All modifications must be made in writing and will be submitted to the Bank/Credit Administration for information before approval takes place. The format in **Appendix B** which was used for the original approval should be utilized and contain updated information concerning:

- Purpose
- Use of Funds
- Background
- Collateral
- Repayment
- Risks
- Financial Analysis (focus on the Six Key Indicators)

The "Reasons" or descriptions in each of the above categories that are affected by the modification requested should be concise.

LOAN REVIEW FUNCTION

Periodic review of all credit extensions is essential to monitoring the risks in any bank's portfolio. It provides a secondary benefit by enabling the bank to pro-actively identify and manage risks as early indications of problems emerge.

Risk Review

The Loan Review Department, working under the Chief Credit Officer, will maintain a continuous review of all loans, facilities and other credit risks, which the Bank assumes. The department will schedule its work so that each individual credit exposure (including every loan and facility) will be reviewed at least once a year and more often if needed. Special attention will be given to credits, which are past due. All loans and facilities will be examined to assess their quality and to insure that each loan has been approved, documented and funded in accordance with the Bank's policies and procedures as well as instructions from the Central Bank of Iraq.

The Department will:

- Risk rate all loans and facilities in accordance with standards to be established by the Bank. A well-designed risk rating system will, in effect, assign a broad probability of successful repayment to each extension of credit and also provide information to management with respect to those loans whose quality is impaired and must be provisioned or written off.
- Identify expected losses in individual credits and classify these credits appropriately.
- Identify credits that require special handling or expertise to assure collection, and designate them for transfer to the Settlement or Legal Department, as appropriate.
- Locate and identify deficiencies in documentation and report these to the responsible parties and monitor remedial actions.
- Identify and report any exceptions to the Bank's loan policy.
- Oversee the operation of the credit portfolio Risk Rating system and insure its continuing validity.

Portfolio Review

A bank's loan portfolio generally comprises its largest risk asset group. Portfolio management is based on several principles and guidelines:

- The quality of the portfolio is the sum of the quality of the individual loans.
- Risk can be increased or reduced for a level of return (yield) depending on how the portfolio is concentrated or diversified. Generally, higher risks are compensated by higher rates.
- Diversification by customers groups (do not concentrate lending to a small number of borrowers with large loan or facility amounts) serves to reduce overall risk.
- Diversification by industries.
- Geographic diversity. Avoid concentrations in loans from the same local, national or cross-border geographic region or economic area.
- Diversification by loan maturities. This means that not all loans are concentrated in the same maturity band or expire during the same period.

The result of good diversification is a reduction of risk *on an overall portfolio basis.* This means that a Banking unit with good diversification can generally take on somewhat riskier assets than a Bank with a concentrated portfolio.

A good management information system will assist a Bank in managing its portfolio by presenting organized and timely information with which to measure inherent risks. Management will be able, therefore, to issue instructions or write policy guidelines that focus on the kind of loans it desires in its portfolio over time.

LOAN RESTRUCTURING GUIDELINES

Changes to an approved loan may become necessary for a variety of reasons. Some are major and result from some of the factors mentioned above which have become aggravated, and which may have a significant impact on risk. The Iraqi economy has experienced difficulties in general in past years given the impact of sanctions and the wars. While some companies have had difficulties in expected business activities, others have continued to operate profitably and according to their plans. In considering the specific request of borrowers for a restructuring, the Bank should look at each request on a case-by-case basis. Restructures of principal repayments or other modifications that materially change the payment terms of the original Loan Agreement should be examined carefully.

Following are guidelines for restructuring loans:

- The borrower should request the restructure in writing.

- The request should indicate specific reasons for the restructure, defining why there is a problem and how it impacted the original loan recommendation, financial condition and future projections.

- The request should be accompanied with a current balance sheet, income statement, and accounts receivable and accounts payable aging.

- The request should demonstrate how the restructure would solve the problem causing the request.

- The borrower should be willing to extend additional collateral to cover the added risk.

- Terms and conditions should be tightened to reflect the now riskier lending scenario. Consideration should also be given to requiring increased financial reporting to the Bank.

- Additional interest on the outstanding balance should be considered in view of the additional risk. It should be cautioned, however, that for a borrower in very serious difficulty, this might only serve to compound the problem and hasten a failure.

There may be other bank-specific policies that should also be followed in dealing with restructure modifications. In any event the approval process for restructuring a loan should follow the process guidelines mentioned above.

PROBLEM LOANS

In cases where the risk of credit loss is significant and/or the underlying problems require special expertise, the Main Office Settlement Department (supported as needed by the Legal Department) will assume primary management of the problem credit, keeping in mind that the originating Branch Manager will remain available to coordinate recovery actions as required. Normally any loans or facilities past-due for more than a specified number of days, frequently ninety, will automatically be transferred to the Settlement Department. In cases where there is an imminent risk of loss, the loan should be transferred without regard to the number of days it may be past-due, and even if it is still current. At that same ninety-day point (or other time limit set by Bank policy), all interest accrual should cease and any interest already accrued and taken into income should be reversed. The assigned risk rating should be changed to accurately reflect the loan or facility's current deteriorated condition.

The Settlement Department will be responsible for the following:

- Examine and evaluate the problem credit situation including an assessment of the risk, a review of the adequacy and completeness of credit documentation, and, if applicable, collateral perfection, as well as an analysis of the condition, marketability and current market value of the collateral.
- Formulate a future strategy or an action plan to be followed in dealing with and resolving the problem credit.
- Retain outside counsel to provide specialized legal assistance when required.
- Implement a strategy in order to restore the credit to a fully performing status or get the outstanding balance fully repaid, restructured, or adequately secured to mitigate against loss.
- Estimate the probability of full recovery and the likely costs (in terms of actual expenses, employee time and foregone income) associated with succeeding. If there is a low probability of full recovery coupled with high costs over an extended period of time, the Bank, through action of its Credit Committee, might make a business decision to attempt to settle the debt immediately for less than the full amount owed, taking a smaller (and certain) loss now as opposed to a possibly larger (and uncertain) loss later.

Prompt and effective resolution of problem loans can reduce losses for the bank. Problem loans are costly to the bank in terms of time and effort as well as, frequently, foregone interest income and additional expenses. Ultimately problem loans reduce profits and can erode capital.

THE CREDIT FILE

Definition

Credit files that are accurate, comprehensive, and current are vital to properly managing credit risk. The files also serve as the historic record of client relationships. Credit files are the basis for approvals, for independent internal credit or audit reviews, as well as external reviews by examiners who test for credit quality, compliance with Central Bank of Iraq regulations and Bank policies, guidelines, procedures, and internal controls.

Contents

The contents of a credit file will vary depending on the transaction, amount and type of financing involved. However, the credit file should enable a reviewer to make an independent judgment of the credit and the rationale or credit logic underlying the credit decision. Active credit files should contain current pertinent information and cross-reference other relevant information in other files. It should contain all relevant documents including a copy of Application Form, the Loan or Facility Agreement and Transaction Recommendation. It should also contain all documentation relevant to Guarantees and Real Estate Collateral, registered moveable assets, cars, etc. It will also containing all supporting documentation listed in Appendix A. The credit file must be prepared by Branch Credit Administration within 24 hours, or as soon as feasible, after the loan application has been received and will accompany the recommendation to the highest Credit or Advisory Committee for approval.

APPENDIX A: LOAN APPLICATION

Date: Bank Branch:

CLIENT INFORMATION	**Sole owner:** ☐ **Individual:** ☐ **Other**: ☐	**Limited liability company:** ☐	**Joint liability company:** ☐	**Mixed company:** ☐ **Partnership:** ☐

Name of Applicant:

Address:

Tel:________________ **Mobile**________________ **Fax:** _________________ **E-mail:** __________________

Type of business:

LOAN REQUEST

Amount: **Requested repayment term:**

Purpose (be specific):

Total project cost: ____________________ **Borrower's contribution:** _____________________

COLLATERAL

Description:

Cost: __________________ **Date purchased:**_______________ **Present market value:** ____________________

Guarantors (if applicable):

ATTACHMENTS (check documents attached)

☐ business plan, including complete business description, date founded, number of employees	☐ names of main shareholders and percentage of ownership
☐ balance sheet	☐ statute of the borrower
☐ profit and loss statement	☐ legal opinion
☐ personal financial statement	☐ collateral description and ownership documents
☐ guarantor's personal financial statement	☐ insurance certificate
☐ civil identity	☐ invoices
☐ national identity card	☐ rental agreement
☐ professional identity	☐ other:
☐ housing certificate	☐ other:
☐ food supply card	☐ other:

_______________________________ ______________

(Authorized signature of the applicant) **(Date)** **(Seal of the Company)**

FOR BANK USE ONLY	Existing / new client	Application number:
Date sent to Credit Department:		Branch Manager signature:

APPENDIX B :

LOAN RECOMMENDATION

Borrower		Date		Number	

Address	

Business type	

Loan purpose	

LOAN AMOUNT			
New loan amount		Total Bank exposure	
Existing loans balance		Debt at other banks	
Existing facilities total		Total bank debt	

New Employment	Year 1	Year 2	Year 3	Total	Risk Rating	Borrower	Loan
						N/A	N/A

Term/Maturity		Client since	
Grace period		Ownership/percentage	
Interest rate		Repayment source	
Payments/Installments			
Collateral			
Guarantors			

Loan officer's transaction summary

(Use additional pages if necessary)

Approvals	Name	Signature	Date
Loan Officer			
Loan Analyst			
Head of Loan Department			
Head of Credit Department			
Credit Committee			

Financing sources and uses					
	Costs	Bank's loan	Internal Financing	New Equity	Other Financing
Equipment					
Total Equipment					
Buildings/real estate					
Total Buildings/Real estate					
Working Capital					
Total Working Capital					
TOTALS					

Collateral description	
Existing assets	Present Value
Total Existing Assets	
New Assets	
Total New Assets	
Total Collateral	

<u>Description of the Borrower</u>

Legal form: **Number of employees:_______**

Ownership:

History:

Organization:

Products:

Markets and marketing:

Competition:

PRIMARY CUSTOMERS	CITY/COUNTRY	% of SALES

PRIMARY SUPPLIERS	CITY/COUNTRY	RAW MATERIALS

Management:

Key Management				
Name	Position	Age	Education	Years. in Industry / Company

Financial Analysis:

HISTORICAL
Personal Financial Statement (date:___________)
Comments:

Business Balance Sheet (date:___________)
Comments:

Aging of Largest Accounts Receivable as of:					
Buyer/City	Receivable Amount	0-30 days	31-60 days	61-90 days	90 days +
All others:					
Total:					
Percent of Total:	100%				

Aging of Significant Accounts Payable as of:					
Seller/City	Receivable Amount	0-30 days	31-60 days	60-91 days	90 days +
All others:					
Total:					
Percent of Total:	100%			%	%

Income Statement (Period:______months ending:______________)
Comments:

PROJECTIONS
Income Statement
Comments:

Cash Flow Analysis:

	Year 1	**Year 2**	**Year 3**
Cash Coverage: (Net profit after tax + depreciation) / Loan principle due			
Working Capital Adjusted Cash Coverage:	N/A	N/A	N/A

Strengths:

Weaknesses:

Risk and Mitigants:

Risk:

Mitigant:

Risk:

Mitigant:

Environmental Considerations:

Conditions Precedent:

- Standard Documents

Loan Covenants:

- Standard Documents

APPENDIX C: MONITORING DOCUMENTS

Loan Control Form and Company assessment

Company ____________________

Date ________________________

1. Loan information:	Principal outstanding	Past due interest
2. Financial information	Current period	Previous period
Total assets		
Total liabilities		
Net worth		
Sales		
Gross profit		
Operating profit		
Net profit after tax		
3. Key ratios and margins		
Current ratio		
Leverage ratio		
Gross profit margin		
Operating margin		
Debt service coverage ratio		

4.Comments/ description of significant changes in the financial condition of the company

5. Assessment of collateral	Yes	No
Is there any change in the collateral condition Is there a risk of deterioration of the collateral		
	Current period	Previous period
Value of the collateral Loan coverage %		
6. Assessment of subjective factors		
Describe any changes in collateral condition.		
Describe changes in Management and key personnel. Evaluation.		
Describe any important changes in the company. Progress. Difficulties.		
7. Loan Rating	Current period	Previous period
Standard/watch/substandard/doubtful/loss		

APPENDIX D: RISK RATING SYSTEM

It is the responsibility of Bank Management to insure that all credit exposures are rated at inception using this system and that these ratings are maintained currently and accurately for each borrower. All ratings shall be reviewed at least on a quarterly basis.

It is important that all staff recognize that assigning risk ratings is a subjective endeavor, which will be successful only to the extent that each individual exercises good judgment based on experience and common sense coupled with good analytic techniques.

Risk Rating Scale for Commercial Loans:

In determining the borrower risk status, the Bank's Credit Administration should evaluate a borrower's current and prospective performance according to the following graded criteria:

Standard Risk:	1
Watch List:	2
Substandard:	3
Doubtful:	4
Loss:	5

1. Standard Risk

An asset classified as Standard is supported by sound net worth and paying capability of the borrower. Standard assets represent normal performance and involve a general credit provision of 2%.

2. Watch-List

An asset classified as Watch-List is adequately protected but is potentially weak. Such an asset constitutes an unwarranted credit risk but not to the point of requiring a classification of Substandard. The credit risk may be minor, and in most instances, bank management can correct the noted deficiencies. Yet such risk is considered undue and unwarranted in light of the particular circumstances surrounding the asset.

A. Examples of Watch-List assets are those which may, if not corrected, become weakened by imprudent lending practices including but not limited to the bank loan officer's inability to properly supervise them due to lack of expertise; failure to maintain adequate and enforceable documentation or poor control over collateral.

B. Watch-List assets require a minimum credit provision of 10%.

C. In no circumstance should a Watch-List category be utilized as a compromise between the classification categories of Standard and Substandard.

3. Substandard

An asset classified as Substandard is inadequately protected by current sound net worth and paying capacity or by the collateral, if any, supporting it. Such an asset has a well-defined weakness that jeopardizes the liquidation of the debt. It is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Assets that are past-due 61-90 days for principal or interest payments must be classified as substandard at a minimum. Substandard assets require a minimum credit provision of 25%.

4. Doubtful

An asset classified as Doubtful has all the weaknesses inherent in one classified as Substandard with the added characteristic that these weaknesses make collection or liquidation in full, on the basis of current circumstances and values, highly questionable and improbable. Although the possibility of loss is thus extremely high, because of significant pending factors, reasonably specific, which could be expected to work to the advantage and strengthening of the asset, its classification as a estimated loss is deferred until its more exact status may be determined. Examples of such pending factors include but are not limited to mergers, acquisitions, capital restructuring and the furnishing of new collateral or realistic refinancing plans. Assets that are past-due 91-180 days for principal or interest payments must be classified as doubtful at a minimum. Doubtful assets require a minimum credit provision of 50%.

5. Loss

An asset classified as a Loss is considered not collectible and of such little value that its continuance as a bankable asset is not warranted. A Loss classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. An asset that is past due over 180 days for principal or interest payments must be classified as Loss. Loss assets require a credit provision of 100%.

APPENDIX E: WORKING CAPITAL LOANS AND FACILITIES

Purpose

This Appendix will provide guidance on how to structure working capital loans and facilities.

Working Capital Loans/Facilities up to 12 months
These are short-term loans to boost inventories and receivables in support of increasing sales, which are repaid from the cash conversion of short-term assets, mostly receivables and inventory.

Financial analysis for facilities or loans to be used for this purpose should focus on past performance of inventories and receivables in terms of turnover and asset quality together with reliable client information related to anticipated levels of sales. It is important to monitor inventory purchases, sales levels during the period and the collection of receivables. Ample information about key buyers and suppliers is important to have.

Since it is “called” a working capital loan, it is best described, as a working capital loan for financing receivables and inventory - don't forget that it is for up to 12 months, and has a specific purpose and a specific source of repayment. Seasonally related finance is an equally good way to describe this kind of product.

All short term working capital loans should be repaid in full periodically, preferably once a year for at least 30 days. This should be the case whether the finance is provided by means of a facility or a loan.

Working Capital Loans up to 36 months

Working capital loans can be made for more than 12 months. The difference between short and long is related to the theory of working capital - when finance is provided on a long-term basis, working capital in a measurable, accounting sense actually can increase until loan proceeds are used. It may be called "permanent working capital" but the underlying finance has to be repaid, in this case out of positive cash flows, essentially profits plus depreciation and positive flows from working accounts, not conversion of assets. Consequently, anticipation of repayment is based on projected profits/margins that are reasonable and realistic.

When are longer-term working capital loans made? There are no hard and fast rules except that such loans are not repaid from specific asset conversion as noted. Longer-term working capital finance may be supplemental to longer-term equipment/investment purpose loans and provides a project with funds to support project success. Increased sales (it may take some time to reach appropriate levels), higher profits and profit margins, and depreciation are the funds sources that repay long-term working capital loans. Deciding when long-term working capital loans are appropriate is a matter of good financial judgment combined with good financial analyses of cash flows and understanding of the project. (See appendix F)

APPENDIX F: TERM LENDING

Kinds of Term Lending

Commercial banks generally define term loans as those having maturity in excess of one year. They are made for many purposes, among others, to supplement working capital and most commonly to finance the purchase of modern machinery and equipment. Depending on the purpose of the financing and cash flows, term loans could have a final maturity of up to eight years, although three to five years is more common.

The repayment of term loans, therefore, is not expected to be the result of asset conversion as is the case of seasonal financing to support inventory and receivables buildup; funds for repayment are expected to be generated by the asset (s) financed and repayment should conform to the anticipated levels and timing of cash flows.

Acquisition of Plant and Equipment - loans for fixed asset expansion are the most common and easiest from a risk analysis standpoint to justify. The economic benefits of fixed asset expansion are demonstrable provided the proper financial statements and projections are available and a borrower's past performance is positive and can help guide the credit decision.

Working Capital – term loans for working capital purposes are perfectly in order when a company has grown so fast that internal capital formation has not kept pace at normal levels, or fixed asset expansion requires additional support to be viable. These loans are more difficult, however, to analyze from a risk standpoint. The banker as well as the borrower will have to anticipate higher earnings that are sufficient to retire the debt on a timely basis and cash flow analysis has to support this expectation.

Project Financing - Term loans to finance new ventures or projects are the most difficult to analyze and approve. Frequently, the economic feasibility of projects is unknown and must be subject to market studies and technical appraisals including the prior identification of supplier and buyer commitments. However, good historical performance and operating practices are vital to creditworthiness.

The risks involved in project financing, in addition to mortgage collateral, must often be offset by third party undertakings (written commitments from suppliers and buyers), completion guarantees, shareholder undertakings and of course these risk mitigations must be properly documented.

Analytical Approach to term lending

The analysis of an application for a term loan involves basically the same techniques that are used in the analysis of short-term loans and facilities. However, since repayment is expected largely from the asset financed the emphasis shifts from the balance sheet to the income statement and more specifically, to the company's cash flows over the life of the loan and the profit margins available to cover interest payment and principal amortization.

The raw material for a thorough financial analysis should include at least three prior years of financial statements if possible, preferably certified by an independent accountant. In addition, pro forma balance sheets, income statements and cash flow calculations for the anticipated life of the term loan (projections), are prepared by the borrower. The lender should not have to prepare these projections; there are many uncertainties in making pro-forma statements. They are based largely on historical business performance together with anticipated results from the term financing and many assumptions have to be made concerning both balance sheet and income statement items. The banker is best served by studying pro-formas prepared by the borrower and questioning/revising the assumptions underlying the projections as required.

The projected balance sheets and income statements for each year should also include annual cash flow statements. These will take the total income and depreciation for each year, add or subtract the net changes in operating accounts (essentially receivables, inventories and payables) to derive total cash from operations for the projected year. The resulting number is a rough approximation of the cash from operations that is available for debt service for each year, i.e. interest and principal payments. Obviously, cash from operations should exceed debt service requirements by a healthy margin.

Documentation of Term Loans

Every loan transaction involves risk. However the risks involved in a 90-day loan are generally predictable, while the risks involved in a five-year loan cannot be easily assessed. The loan agreement, or contract, for a term loan should protect the lender against unforeseen and foreseen risks and should allow the lender to control many of the borrower's business dealings as well as permit the lender to step into the picture and take steps to solve problems while the borrower still has some flexibility to help solve them.

The utility of such a loan agreement is enhanced if frequent monitoring of the borrower's activity takes place during the life of the loan.

At a minimum, a term loan agreement should permit the lender to accelerate the maturity of the loan if principal and interest are not paid on time or certain conditions of lending are not met. This provides “control”. Each term loan agreement should be “tailored” to fit the financing, its purpose, and the circumstances of the borrower. A good term agreement will describe the loan, its repayment terms, the purpose of the financing, and describe the collateral. It will require that loan funds be used for the purposes of the loan. It may contain completion dates. Frequently financial ratios, such as a current ratio or debt to worth ratio are required so that the banker can monitor the financial condition of the borrower. It may require that dividends not be paid before the bank is paid to preserve working capital and there may be limitations on total indebtedness with or without the consent of the lending bank. Changes in corporate structure or corporate name may be prohibited along with sale of key assets without lender consent. It may limit investment in other companies, prepayment of other long-term debt, or impose limitations on executive salaries. The Agreement may also call for “progress reports” from the borrower. As noted, each term loan agreement is a “custom” document and there may be a great variety and number of provisions. The latter are a function of the possible risks involved during the life of the loan.

Monitoring of Term Loans

The term loan agreement itself provides the key basis for monitoring. A violation of any of the above mentioned provisions called “events of default”, for example, may occasion a letter or warning, acceleration of indebtedness, or lay the groundwork for dealing with serious business problems or changes in the borrower’s risk profile that existed when the loan was made. A borrower is expected to notify the lender when there is a default or in anticipation of a possible default. A properly drafted Agreement, properly monitored, applicable to a term financing project that on the basis of good risk analysis will guide both borrower and lender to help ensure project success as well as repayment.

APPENDIX G: REAL ESTATE LENDING

Purpose

This Appendix will provide guidance on how to structure acquisition and bridge loans, and loans for the construction and development of real estate. These are generally loans for shorter term needs (three years maximum). Term loans secured by real estate are discussed under the Appendix covering "Term Loans". Land acquisition loans for agricultural or other commercial purposes, secured by real estate, are discussed in other appendices.

Acquisition/Bridge Loans

Borrowers may require loans to acquire buildings and properties to supplement their business needs. An example would be if a manufacturer has the opportunity to purchase a tract of land, which would be required for the future expansion of his plant. In most cases these loans are required when the borrower/buyer has a need to immediately make the purchase where he has not had the time to develop a specific plan for the use of the property to be purchased. The problem for the Bank is that there is no identifiable source of cash flow from the real estate acquisition to repay the loan. In this case the Bank must identify and depend upon alternative sources of cash to repay the loan. An Acquisition/ Bridge loan should never be granted for the purpose of speculation in real estate investments.

In this situation, the Bank must reasonably determine that funds will be available at some defined future date to repay the loan. Unless this can be determined the loan should not be approved. Sources would primarily be financing from another source either within the Bank or externally. If the source is external, the Bank should obtain a binding commitment. Additionally, the Bank needs to qualify the source to determine that the party financing repayment of the Bank's loan has the financial ability to fund the payoff. Sources could include (but are not limited to) other financial institutions, Iraqi Government Agencies, or international organizations. The Bank should make every effort to ensure that the commitment from the outside source to repay the loan is binding. If there are conditions associated with the commitment, the Bank should require that these conditions are met before the Bank approves the loan, or in limited cases ensure that the borrower has the ability to fulfill all conditions in a timely manner.

In some cases the borrower/purchaser may desire the Bank to make a loan at a future date to repay the Acquisition/Bridge Loan. This would be the case where the borrower will, at a specific future date, present the bank with another proposal to finance the construction of a facility, or other improvement on the property, which would create utility (cash flow) to the borrower. In this case the Bank needs to determine at the time of request of the

Acquisition/Bridge Loan an approximate amount of the needed future financing and ensure that the borrower has and will have the ability to qualify for that amount. Also the Bank must determine any impediment (legal, physical, or other), which would preclude the use of the property for its intended purpose.

Construction Loans

These are loans to be used to construct facilities and buildings on property. Construction loans should only be granted to borrowers who demonstrate the expertise and capability to complete the proposed construction within the stated period at the planned cost. Delays and cost overruns will very negatively impact the ability to complete the project. Funding of the loans should be staged in portions over the life of the loan. The Bank needs to analyze the construction project and determine acceptable stages of completion of the project to establish identifiable points of completion when agreed upon amounts of the loan will be funded to continue the construction through the next stage. This requires the Bank to be presented with a full set of final architectural and engineering plans, specifications for materials and construction, and a full cost budget, including all “hard costs” (labor, materials and subcontract work) and “soft costs” (architect, engineering fees, costs of permits), including a provision for unforeseen contingencies. The Bank will analyze these materials, or may require the review of an expert of its choice to determine that the materials and costs presented are reasonable to complete the project. The loan structure should require use of the borrower’s own funds as equity to initiate the project and carry it through its early stages before any loan funds will be advanced. The borrower should be required to provide verification that all subcontractors and laborers have been paid for their work to date as a pre-condition to funding of subsequent loan advances. Upon request of the borrower for more loan funds, the Bank needs to inspect the construction to ensure that the project has reached the next planned stage of completion. This inspection should also make sure that the quality of the construction is acceptable. This process should be explained in detail to the borrower to ensure it completely understands the funding mechanism.

The second major challenge for the Bank is to ensure that upon completion of construction, funds are available to repay the loans. This requires that the purchaser for whom the project is being constructed provide proof that it has the ability to pay for the completed project in an amount sufficient for the contractor to fully repay the Bank’s loan. In most cases the Bank should require that the purchaser submit a letter of guaranty from a sound financial institution guaranteeing payment upon satisfactory completion of the project. The Bank must carefully review the conditions of the letter of guarantee to ensure that any and all conditions can be reasonably fulfilled. In some cases the purchaser may offer some other form of guarantee acceptable to the Bank. Investigation of the purchaser’s financial condition may also be warranted.

Land Development Loans

These are loans to develop the necessary infrastructure such as roads, and utilities on a piece of property for sale to accommodate future construction. This type of loan will be explained at a future time.

APPENDIX H: CONTRACT LENDING

Purpose

This appendix will provide guidance on how to originate and structure loans to permit a borrower to perform the work required under the terms of a contract. This arises from the situation where a borrower obtains a contract to provide services to a customer. Examples would be contracts to supply communications, highway construction, utility construction, and building renovations, among others.

Contract Financing

Essentially Contract Financing is a form of working capital financing. The primary difference is that the primary source of repayment is the anticipated proceeds from a specific contract to provide services. The first determination the Bank must make is that the borrower is qualified to provide the services required. This means the bank must ensure that the borrower has adequate expertise, experience and physical resources to successfully complete the job.

After this determination is made the Bank must analyze the specific contract to determine if performance by a contractor is reasonably possible in the ordinary course of business. The Bank must also ensure that the issuer of the contract has the financial capability to make required payments. If a Government Ministry issues the contract this task may be rather simple, however any contract issued by private entities must be thoroughly reviewed. The Bank needs to examine in detail the terms and conditions to determine that the contract has no conditions which cannot be reasonably fulfilled by the borrower. This includes analyzing the contract to determine that its amount is reasonably adequate to fund the completion of the project. The Bank should then determine readily identifiable and appropriate stages of contract progress against which to advance funds to make sure that they match scheduled progress and planned expenditures. Advancing in this manner insures that funds required to complete the remainder of the project are available to the contractor so the work continues smoothly, but excess funds, which may potentially be diverted to other uses, are never advanced. Requests for progress payments should be accompanied by proof that the borrower has paid for all materials and labor used up to that date. This financing should cover only working capital aspects of the borrower’s needs such as labor costs and materials to be used in the project. Capital asset acquisition should not be included in Contract Financing.

The Bank should take an assignment of the contract and require that all payments by the contracting party (the issuer) to the contractor (the borrower) under the contract be remitted directly to the bank. There should be a mechanism in place, agreed to by the borrower and the Bank, about how such progress payments will be allocated between the two parties (some to the borrower and some applied to the loan). Close contact should be maintained with the issuer of the contract to be sure that nothing impairs further funding of the contract. Working capital, which is required to be furnished from the borrower's own funds, should be injected at the initiation of the project, prior to the first advance under the Bank's loan. Periodically the Bank should visit the project site to verify the actual progress of the job. Whenever the Bank is requested to issue a "Bid Bond" or "Performance Bond" it should follow the same steps and anticipates that it may ultimately be required to furnish Contract Financing in order to generate the funds necessary to successfully exit its initial commitment.

APPENDIX I: AGRICULTURAL LENDING

Purpose

Guidance to structure the most common short or long-term agricultural loans.

Specificity of Agricultural Loans

Loans to the agricultural sector bear very specific risks. They need particular attention and the terms should be based on the purpose for which the loan was made. In addition to the usual risks inherent to other sectors of the economy, agriculture is affected by natural or climatic conditions, which can have a negative impact on the yield and the quality of seasonal crops, or simply destroy them. Long-term investments such as tree plantations can be eradicated; cattle and poultry are prone to diseases and epidemics. All these factors must be taken to consideration when granting a loan to this sector. In addition, loan structure must take into consideration the natural and seasonal cycles and match the loan repayments in an appropriate manner matching these cycles. Typical collateral is land, farm buildings and equipment. Collateral based upon future crops or livestock is extremely risky, unless insurance is available.

Types of loans

- Loans for purchasing seeds, fertilizers, fuel, small tools and finance labor costs: These loans are usually short-term working capital loans used to finance the growing cycles of various types of vegetables and crops with a short maturing cycle (six months average). These loans will be structured to match scheduled repayments with the selling season. Unless the borrower has other revenues, repayments will not start before the end of the cycle and may be repaid in one single increment or over a very short period of time.

- Loans for acquisition of dairy or feeder livestock and poultry: These loans are short-term loans under one year. They are self-liquidating from the proceeds of sales from feeder operations or are repaid from the cash flow generated by the sale of milk from dairy livestock.

- Investment loans:

    - Long-term (beyond one year) investment loans for agricultural producing assets such as orchards, with two to three years yielding period. Unless the borrower already has other sources to repay the loan within a short period of time, these loans will require a long grace period before initial cash flow is generated, which the bank may not want to consider.

- Loans for construction of greenhouses to grow produce and flowers. The cycle of production is usually short and may be repeated several times a year. A grace period may be necessary until the end of the first cycle when cash flow will be generated. Repayments will then be spread over several successive cycles. The duration of the loan will depend on the number of cycles necessary to generate the required cash flow.

- Loans for the acquisition of real estate, machinery or breeding herds. The terms of these loans may exceed five years and necessitate a source of repayment from already existing operations.

Monitoring the loans

As a generality, the bank needs to closely monitor the use of loan proceeds, and insure that funds are used for the intended purpose of the loan and are not diverted to another use. For instance, if a short-term loan for crop production is used to purchase farming equipment, it is likely that the borrower will not have the cash flow necessary to repay the loan at maturity.

Agriculture can be affected by many unexpected natural and climatic conditions, which may generate unanticipated costs or create cash flow shortfalls. In these instances, the bank may have little recourse but to reschedule the maturity of the loan until the next cycle or else provide an additional short-term working capital loan to cover the extra costs.

APPENDIX J: SPECIALIZED LENDING

(For future use)

APPENDIX K

PERSONAL FINANCIAL STATEMENT

If you are applying for a loan or credit facility in your own name, or in the name of a business or other legal entity or if you are providing your guarantee for the payment of that loan or any other existing or future indebtedness to this bank, please complete this form. If you are presently a guarantor of the indebtedness of another person, business or entity, please provide the details in the section titled “Guarantees”.

Personal financial statement as of _______________ , 20___.

PERSONAL INFORMATION	**EMPLOYMENT INFORMATION**
Name:	Company Name:
Address:	Company Address:
City or Town:	City or Town:
Age:	Type of Company:
Telephone:	Years in this Business:

Currency: ( ) Iraqi Dinars ( ) U.S. Dollars			
Assets		**Liabilities**	
Cash on hand		Accounts and bills payable	
Cash in banks			
Receivables due from family		Notes payable to banks	
Receivables due from others			
		Facilities payable to banks	
Real estate – residences		Mortgages payable	
Other real estate			
Businesses owned		Taxes payable	
Vehicles			
Other assets – please list		Other liabilities – please list	
Total Assets		**Total Liabilities**	
Total Assets – Total Liabilities = Net Worth			

Are any of the above assets jointly owned?	Yes / No
Do you guarantee other debt? Yes / No	Total amount:
For whom?	
Are you involved in any pending legal actions?	Yes / No

Annual income		**Annual Expenses**	
Salary, bonus, commissions	______________	Family expenses	________________
Withdrawals from business	______________	Mortgage payments	________________
Rental income	______________	Loan payments	________________
Investment income	______________	Taxes	________________
Other income	______________	Other expenses	________________
Total Annual Income		Total Annual Expenses	

My signature below indicates that all of the information that I have provided on this application for credit is true and correct to the best of my knowledge and belief. I authorize the bank to investigate and verify all of the information provided and to exchange credit-related information and experience with others. A photocopy of this document authorizes others to release to this bank information about their credit experience with me.

Signature: ____ Date:____________________

For bank use only – Verification of Identity:
Documents presented:

APPENDIX L:
BANK GUARANTEE FORM FOR ADVANCE PAYMENT

We refer to the Contract Agreement (the Contract) signed on (date) between (name of buyer) {the Buyer} and (name of the Supplier) {the Supplier} concerning the purchase of ______________(Brief description of the transaction).

Whereas, in accordance with the terms of the Contract, the Buyer has agreed to pay, or caused to be paid, to the Supplier at the Issuing Bank an advance payment (the Advance Payment) in the amount of (amount of foreign currency in words) (amount in figures) or (number) percent (__%) of the Contract. Whereas, the Issuing Bank issues its guarantee (the Guarantee) in connection with this Contract as stipulated below for the benefit of _______________________(Iraqi Bank) (the Beneficiary).

By this letter we, (name of the Issuing Bank), a Bank organized under the laws of (Country of Bank) and having its registered principal office at (address), do hereby jointly and severally with the Supplier irrevocably guarantee repayment to the Beneficiary hereof, the Advance Payment upon the first demand by the Beneficiary without cavil or argument in the event that the Supplier fails to commence or fulfill its obligations under the terms of the Contract and in the event of such failure, refuses to repay all or part (as the case may be) of the Advance Payment made to the Supplier through the Issuing Bank.

Provided always that the Issuing Bank's obligation under this Guarantee shall be limited to an amount equal to the outstanding balance of the Advance Payment, taking into account such amounts that have been paid to the Supplier from time to time in accordance with the terms of payment of the Contract as evidenced by appropriate shipping documents or payment certificates.

This Guarantee shall remain in full force from the date upon which the Advance Payment is received at the Issuing Bank. This Guarantee is valid for up to 30 days after delivery date of (Date), (or completion date as defined by the contract), at the Buyer's place of business in Bosnia (detail Buyer's address or physical location of the final delivery point), to permit filing of claims. If delivery (completion) is not completed (fulfilled) by the delivery date (completion date), then the Beneficiary has until (Date) to submit its claim for payment under this Guarantee.

Any claims to be made under this Guarantee must be received by the Issuing Bank during its period of validity.

Name of the Issuing Bank

Authorized Signature
Date: